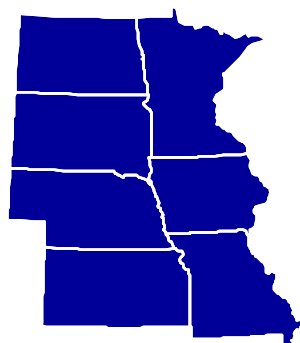

◆ Regional Outlook ◆

FEDERAL DEPOSIT INSURANCE CORPORATION

SECOND QUARTER 1997

In Focus This Quarter

FDIC KANSAS CITY REGION



■ *Will Credit Scoring Transform the Market for Small-Business Lending?* -

In an effort to reduce the cost of small-business lending, some institutions are using credit scoring technology to reduce underwriting costs and to grow their small-business lending portfolios, in some cases venturing into markets well beyond their local economies. The ramifications could be significant. An overreliance on credit scoring models could expose lenders to increased credit risks. Over time, the traditional niche enjoyed by small banks in small-business lending could come under considerable pressure. *See page 3.*

■ *Banking on the Internet: New Technologies, New Opportunities, New Risks* -

Internet banking promises a wide range of new benefits. It also offers a host of new problems and some new twists on old ones. The tradeoff is one that depository institutions and regulators alike must grapple with as they stake out their positions in cyberspace. *See page 7.*

DIVISION OF INSURANCE

Regular Features

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Will Credit Scoring Transform the Market for Small-Business Lending?

- **Small-business lending, traditionally a segment in which small banks have enjoyed comparative advantages, is receiving greater focus from larger banks and nonbank financial companies.**
- **Some insured institutions are beginning to re-think traditional approaches to small-business loan underwriting to include the use of credit scoring models.**
- **The use of small-business lending credit scoring models, while providing banks opportunities for underwriting and servicing efficiencies, carries with it a number of potential risks.**

Background

As of 1994, there were more than 22 million small businesses in the U.S., making this a very attractive potential market for lenders. Small-business lending has been a line of business in which small banks have been very successful given their traditional strong niche in relationship banking. Small-business lending traditionally has been a relatively cost-intensive lending segment, since origination costs are spread over smaller loan balances. Some institutions are now beginning to use credit scoring technology to reduce underwriting costs and to grow their small-business lending portfolios. A number of larger banks, especially, appear to be looking to the efficiencies of credit scoring to help provide quick loan approvals and more competitive loan rates. With the aid of this technology, some institutions are rapidly expanding their loan portfolios, in some cases venturing into markets well beyond their local economies.



Commercial bank small-business lending exposures in the Kansas City Region are considerable. (For purposes of this article, small-business lending refers to loans categorized as commercial and industrial loans with original amounts of \$1 million or less reported on the June Call Reports.) At midyear 1996, commercial banks in this Region reported \$21 billion in small-business loans, amounting to 55 percent of all commercial and industrial loans. This level is an increase of

\$1.2 billion, or 6 percent, from one year ago. There are 722 banks in the Region with small-business loan exposures exceeding 100 percent of equity, and 124 of those have exposures exceeding 200 percent of equity.

In the Region, small-business loans are fairly evenly distributed among large banks (those with over \$1 billion in assets), small banks (those with under \$100 million in assets), and midsized banks. However, as illustrated by Chart 1 (next page), the Region's large banks dominate the market for small-business loans over \$250 thousand, while the Region's small banks control the market for business loans under \$100 thousand. Clearly, the Region's large banks and small banks have historically concentrated their lending efforts toward different segments of the small-business sector.

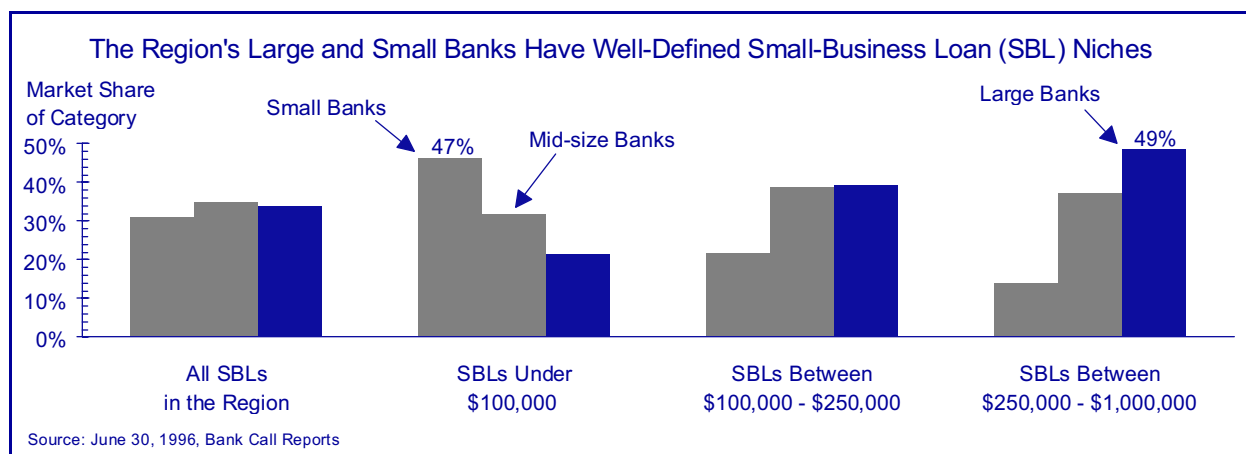
However, recent trends indicate that large banks are increasing their efforts to compete with small banks for smaller business credits. While mid-1996 data do not indicate that the Region's small banks are losing market share, the Region's large banks do appear to be making inroads in the market for business loans under \$100 thousand. Large banks grew such credits by almost 6 percent in 1996, while small banks posted 4 percent growth. This trend is likely to become more pronounced as some of the Region's largest banking companies have recently announced nationwide programs to increase their market share of small-business lending. These programs may have been prompted by the new credit scoring.

The Growing Importance of Credit Scoring

While credit scoring technology is not new, until recently it typically has been associated with consumer lending, particularly with credit card lending. Primarily using credit bureau information, credit scoring provides lenders with a tool to rank risks or probabilities of default, assigning statistically derived numerical ratings or scores based upon a borrower's past experience with paying debt. Based upon the enormous volume of historical information on consumers contained in credit bureaus, model developers link incidences of good and bad credit performance with borrower characteristics.



CHART 1



Applicants then are compared to these credit performance indicators in order to make credit extension decisions. While credit scoring has helped consumer lenders reduce origination costs and to grow receivables at rapid rates, the recent rise in credit card charge-offs has raised concerns about the effectiveness of such models, or at least about how the models are being used.

Small-business credit scoring is a relatively new concept in scoring technology, but is gaining more attention from lenders. *Small-business credit scoring models are similar to consumer credit scoring models in one significant aspect -- the most important indicator of credit performance is the credit profile of the principals of the business derived from consumer credit bureau information.* Other business information from companies such as Dun and Bradstreet Corporation and Experian (formerly TRW) also is used in the scoring process.

A primary vendor of these scoring models has cited analysis purporting to show that business financial statement information did not prove a useful indicator of credit performance for small-business loans. The reasons for this result may be due to inconsistency in financial statement quality and the difficulty in separating business entity cashflow information from the business owners' activities. Also, the relative importance of principals' credit history and financial statement information in predicting credit performance was found to change somewhat with the size of the business -- the larger the business the more important financial statements become in assessing performance.

Many institutions cite the potential cost savings involved in the underwriting process as one of the most

significant characteristics of credit scoring. In many cases, with scoring technology, loan application processes have been streamlined to one page forms for loans up to \$50,000, not dissimilar to that of consumer loan applications. In some cases, financial statements are not required at all. Reducing paperwork helps to reduce both processing time and costs. Table 1 illustrates how scoring has changed underwriting practices, as reported by one large bank at a recent conference on credit scoring. While it is impossible to know whether the information presented in Table 1 is representative of the way most institutions are using credit scoring models, it is clear that credit scoring may represent a significant departure from traditional underwriting methods.

Part of the reduction in underwriting costs may come from improvements in the allocation of underwriting

TABLE 1

SMALL-BUSINESS LENDING: CREDIT SCORING VERSUS TRADITIONAL LOAN UNDERWRITING			
	1993	1996	1997
PERCENT OF LOANS REQUIRING ANNUAL FINANCIAL STATEMENTS	100%	20%	--
PERCENT OF LINES REVIEWED ANNUALLY	100%	0 - 5%	--
PROCESSING TIME FOR LOANS OF \$50,000 - \$250,000	3 DAYS	1 DAY	1 HOUR
SOURCE: REPORTED BY A LARGE BANK AT A RECENT CONFERENCE ON CREDIT SCORING.			

resources. It has been argued that credit scoring allows banks to more easily identify those applicants which are clearly either approvals or denials. This process would enable banks to reallocate their underwriting resources more efficiently to those loans which pose intermediate risks and require closer attention. Other advantages of credit scoring systems that often are cited are greater consistency in underwriting, better measures for pricing strategies, and the potential to enhance the ability to securitize small-business loans.

What Are the Risks?

Small-business lending has historically been a profitable area of bank lending. This situation is most likely attributable to lenders thoroughly analyzing potential customers, persistently monitoring their performance, and building solid lending relationships. Credit scoring for small-business lending raises the possibility that some banks will forgo the traditional underwriting concepts of relationship lending in favor of a more mass-marketing approach, in a manner similar to credit card lending. To the extent that credit scoring is used to rapidly gain new customers by either targeting out-of-territory customers, or customers with less business experience, the risk profile of an institution's small-business lending portfolio may change. Any such change in profile may be significant due to the risks associated with newer borrowers. For example, new firms tend to fail at an extremely high rate, with 53 percent of new businesses failing within the first four years of inception (see Chart 2). Larger, more established commercial businesses tend not to exhibit such volatile characteristics.

There are potential dangers associated with placing undue reliance on credit scoring models. *The predictive value of any credit scoring system may be substantially diminished if the model is used for unintended purposes or customer types.* Therefore, misuse of a scoring system could expose an institution to considerable losses. Since only the largest banks have small-business loan portfolios large enough to create statistically valid scoring models customized for their own customer base, smaller companies should be especially aware of potential misuse. This risk takes on added meaning when one considers that a \$1 million small-business loan represents substantially more capital to a \$100 million bank than to a \$10 billion bank. Adding further uncertainty, small-business credit scoring has been implemented during a period of relatively strong performance by businesses, with com-

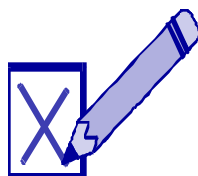
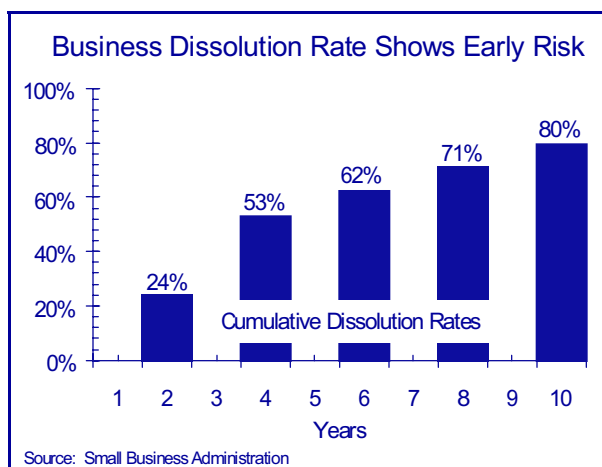


CHART 2



mercial and industrial loan delinquency ratios near historical lows. How well these models perform during an economic downturn remains to be seen.

Depending on the manner in which it is implemented, credit scoring for small-business lending may represent a fundamental shift in underwriting philosophy -- *viewing a small-business loan as more of a high-end consumer loan and, thus, granting credit more on the strength of the principals' personal credit history and less on the financial strength of the business itself.* While this may be appropriate in some cases, it is important to remember that the income from small businesses remains the primary source of repayment of most loans. Banks that do not analyze business financial statements or periodically review their lines of credit may lose an opportunity for early detection of credit problems.

Competitive pressures in small-business lending are increasing not only because of large banks' efforts to expand their lending but also because of greater participation in the market by nonbank financial companies. Several large firms, such as American Express, AT&T, the Money Store, and GE Capital Services, are expanding their business lines to service the needs of small businesses. These companies are offering small-business credit cards, innovative new types of credit, and other services such as consulting, accounting and investment services. Some observers have suggested that the cost advantages of credit scoring may cause small-business lending in the future to be dominated by 12 to 15 large banks or financial firms. Faced with stiff competition, there may be strong motivation for some banks to increase the dollar threshold on low documentation loans, streamline the process for larger loans, or

lower credit scoring thresholds for loan approvals.

The most recent *FDIC Survey of Underwriting Practices* and the *Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices* both indicate that only a small percentage of banks reported an easing of standards on small-business loans. Aggressive competitive pressures and loan growth goals were seen as the main reasons for easing in these cases. With regard to small-business credit scoring techniques, the Federal Reserve survey pointed out that banks were most commonly using credit scores for automatic acceptance or rejection of loans up to \$50,000.

Summary

Credit scoring has the potential to transform the market for small-business lending. The traditional niche enjoyed by small banks in this area may come under tremendous pressure from larger banks and nonbank companies employing this new technology. Credit scoring at a number of institutions is driving dramatic changes in underwriting methods for small-business lending. These changes may facilitate short-term revenue generation as business can be expanded rapidly and underwriting costs can be slashed. It is extremely important, however, that banks understand and control the potential risks inherent in such a strategy. The application of credit scoring to small-business lending merits the close attention of both bankers and their supervisors.

Andrea W. Bazemore, Banking Analyst

Banking on the Internet

New Technologies, New Opportunities, New Risks

- Despite the potential for lower transaction costs, increased efficiency, and greater asset diversification, few banks do business through the Internet.
- Although competitive risks are pushing banks to create an Internet presence, operational risks remain an obstacle to actually using those sites for moving information or money.
- The FDIC's Division of Supervision recently released examiner guidance on Internet banking and is developing training programs for its examiners.

The Allure of Cyberbanking

On-line Banking is a comprehensive term for transactions conducted over wires or from remote locations. It includes banking by telephone, banking by personal computer through a dial-up connection and, more recently, banking over the Internet. Internet banking, frequently referred to as *cyberbanking*, is of particular interest to banks because it exploits an existing and geographically extensive public network infrastructure and promises a range of new operating and marketing benefits. One such benefit is the ability for an institution to expand its trade area to include other cities, states, regions -- or even countries -- without a commensurate expansion of its branch structure. This greater geographic reach can

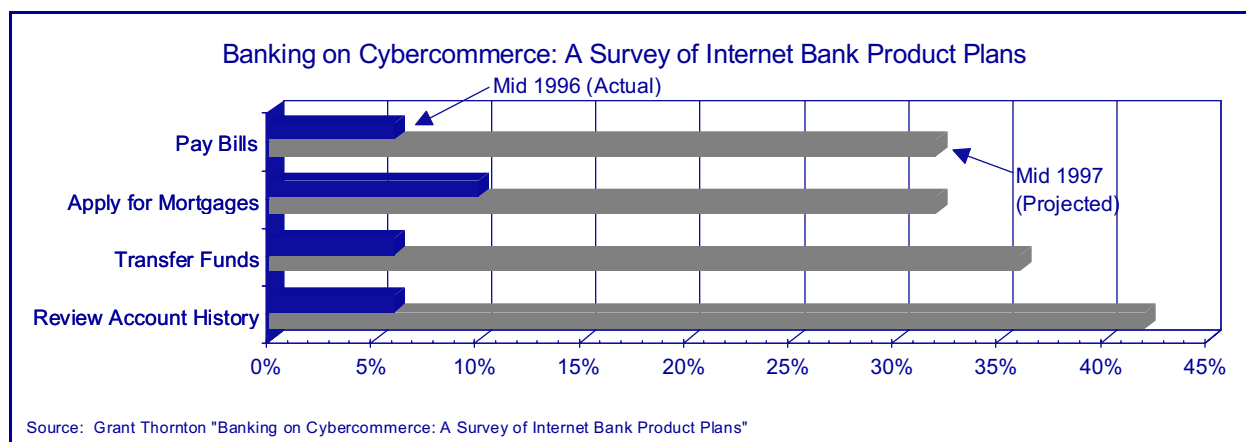


do more than simply increase volume. It also can offer institutions -- particularly smaller ones -- the potential to diversify their asset portfolios across multiple regions, leaving them less exposed to the economic volatility of any single one. Another benefit is the lower cost of Internet delivery. A March 1996, study by **Booz, Allen & Hamilton Inc.** estimated an average Internet transaction cost of \$0.01 compared to \$0.27 for an ATM, \$0.54 for a telephone, and \$1.07 for a full-service branch.

Slow Migration to the Future

Another 1996 study, this one by **Grant Thornton** in July (see Chart 1), found that despite these potential benefits, most banks established an Internet presence for appearance's sake -- being perceived as a leader, advertising bank services or staying abreast of competitors -- rather than with an intent to grow deposits or capture the transaction economies that cyberbanking could provide. Of the 44 Internet institutions surveyed, only one in three expressed intentions to begin offering bill payment or funds transfer over the Internet by the end of the second quarter of this year. Even this subdued enthusiasm now appears optimistic. Despite the perceived benefits and the scarcity of competition, few banks have to date ventured into this area in a meaningful way. According to the **Bankweb** world-wide web site, only 800 or so banks -- less than 1 percent of the industry -- have an Internet site and only 18 of those permit transactions. In the Kansas City Region, 75 institutions have an Internet presence but only one allows customers to pay bills or

CHART 1



transfer funds. A major question, then, is why so few institutions have chosen to exploit this medium?

Risk

The reason is risk. Banks are familiar with the control of exposures found in proprietary or private payment channels, but they are less comfortable with the new risks attendant to a public network. On one hand, there are *operational* exposures that convincingly argue against rushing headlong into cyberspace. On the other hand, there are *competitive* risks. Nonbank competitors with strong foundations in cybertechnology pose a budding threat to the banks' historical payment-services monopoly and argue with equal authority for an immediate Internet presence to gain or preserve market share. These opposing forces help explain the large numbers of banks establishing web sites that stop short of actually moving information or money.

Of these two types, operational risks are the most immediate and command the most attention. They derive from the formative state of both the technology supporting on-line commerce, and the legal and regulatory structure governing its use. These risks include theft or misappropriation of internal data or external transmissions, transaction fraud, errors in underwriting virtual transactions, liquidity shortfalls, changing technical standards, inadequate or geographically inconsistent regulatory and legal infrastructure, noncompliance with existing laws or regulations that were not designed for an on-line world, and damage to an institution's reputation from the realization of any or all of these risks (see *Some Concerns for the CyberBanker*, right).

Systemic Threats and a New Payments Model

In addition to bank-specific risks there are the systemic threats that a public domain payments model could bring. One of the key features of the Internet is redundancy. Any one of a large number of possible paths can be used for a given transaction and therefore the failure of any one path or node will not affect the functionality of the network as a whole. This feature presents a multitude of new and -- from a banker's perspective -- previously unconsidered points of vulnerability to technologically-sophisticated miscreants. In a cyber-world of small value transactions, the effects of an attack may not be much more severe than those which accompany credit card crime. However, there is good reason to expect that Internet transaction sizes will continue to grow. According to one software vendor,

Some Concerns for the CyberBanker

Internal Data Security. The Internet cannot distinguish between customers and criminals. Invasive attacks can range from simple vandalism to theft or destruction of proprietary operating or customer data. Firewall software, data encryption, specialized hardware configurations and commercial insurance can limit such exposures.

External Transmission Security. Because the Internet is an open network, transaction messages are completely exposed, rendering them vulnerable to theft or tampering. Message encryption is a common response, but hardware implementation flaws can circumvent it. This threat will increase greatly if large value or interbank transactions migrate to the Internet.

Transaction Fraud. Fraud takes two forms: misrepresentation during a transaction or repudiation following it. This problem takes new dimensions in cyberspace because no physical relationship with a customer exists. Encryption protocols which include digital signatures are one response. Biometric authentication schemes, the most commonly proposed being fingerprint or retinal verification, are another.

Difficulties with Virtual Underwriting. Even if your cyber-borrowers are who they claim to be, there remain difficulties in establishing their creditworthiness. The lack of a personal relationship is one factor. The limited knowledge of local employers and credit grantors that appear on applications is another. Such difficulties could hasten and heighten dependency upon credit scoring models.

Liquidity Risks. Internet transaction volume and velocity are expected to increase rapidly, potentially creating transactions which occur so rapidly as to exceed immediate bank liquidity. Denial of service attacks, where a site is intentionally deluged with transactions in order to shut it down, also can affect liquidity if affected customers decide to close their accounts.

Lack of Technical Standards. An institution building an early presence on the Internet is making a financial bet as to which standards will endure.

Lack of Regulatory and Legal Infrastructure. Regulators are waiting and observing. Future promulgated "best practices" may not be those which an institution has already adopted. Similarly, a lack of legal precedent hinders criminal and civil prosecution of cybercriminals. Even where precedent exists, it is frequently inconsistent across jurisdictions.

Reputation Risk. An image of solidity is a cornerstone of banking. Internet banking confronts banks with more exposure and potentially greater publicity about losses.

Competitive Risks. Unlike the operational risks discussed above, competitive risks accrue to institutions not securing an Internet foothold. They involve the threat of lost market share or payment system position to more aggressive peers and nonbank competitors.

interbranch payments on the Internet are likely to begin in 1997 with interbank activity to follow a year or so later. This development would be a significant evolution because wholesale transactions are generally large relative to bank liquidity. An attack or disruption of the Internet payments mechanism for a single large transaction could conceivably pass liquidity shocks to other banks in the same way that bad weather at a major airport can disrupt air traffic throughout the country.

New Technologies, Old Reporting

The advent of fully transactional web sites also could heat up bank competition for low cost deposits and frustrate regulatory oversight in the process. One possibility is a "deposit arbitrageur," a hybrid of brokered deposits and program trading in which a computer program could search the Internet for the highest deposit rates and immediately reallocate deposits accordingly. In the long run, such activities could harmonize local interest rates. In the short run, however, this rapid turnover could mean substantial liquidity drains on institutions accustomed to local deposit monopolies. From the regulatory perspective, this transaction velocity -- and its potential to rapidly alter bank balance sheets -- could present new challenges in a world of quarterly Call Reports and examination intervals that can exceed one year.

FDIC -- the CyberRegulator

New risks demand new supervision techniques and the FDIC's Division of Supervision (DOS) has responded with their recently-released electronic banking safety and soundness examination guidance. Under that guidance, institutions having Internet sites are placed into

one of three tiers based upon the "maturity" of their site. Safety and soundness examination procedures focus on bank policies, procedures and planning. The examination procedures are cumulative -- meaning that each successive tier adds an additional level of scrutiny to the tiers below -- and do not require a technical knowledge of Internet systems. "Information Specialist" involvement also varies by tier (see Table 1). A DOS training program for all safety and soundness examiners already has begun, and technical training for information systems specialists is being developed. A new specialty, the electronic banking Subject Matter Expert, also is being established.

Measured Steps in a New Environment

Banks increasingly are becoming distributors of commodity-like products. As such, profitability may become dependent upon both cost efficiencies and high volume -- a combination sometimes argued as inconsistent with high-cost branch structures. Internet banking offers institutions a means to compete in this new environment. It also offers new risks. Recognizing this tradeoff, many banks have entered this realm with measured steps. Those who have not face risk of a different sort. They face instead the risk that their competitive position will pass to more innovative competitors -- competitors with new technologies and the drive to accomplish old business in thoroughly new ways.

Gary Ternullo, Senior Financial Analyst
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TABLE 1

THE DIVISION OF SUPERVISION CLASSIFICATIONS FOR INTERNET BANKS			
	<i>LEVEL 1</i>	<i>LEVEL 2</i>	<i>LEVEL 3</i>
DESCRIPTION	AN INFORMATION-ONLY SITE	A SITE PERMITTING ELECTRONIC SUBMISSION OF LOAN OR DEPOSIT APPLICATIONS	TRANSACTIONAL SITE OFFERING ELECTRONIC BILL PAYMENT OR FUNDS TRANSFER SERVICES
SPECIALIST EXAMINATION REQUIREMENT (IN ADDITION TO SAFETY AND SOUNDNESS EXAM)	INFORMATION SPECIALIST REVIEW REQUIRED ONLY IF SITE IS TIED INTO INTERNAL BANK SYSTEMS.	CONSULTATION WITH INFORMATION SPECIALIST REQUIRED TO DETERMINE IF FURTHER REVIEW IS WARRANTED.	CONCURRENT INFORMATION SPECIALIST EXAMINATION REQUIRED.

For More Information:

Division of Supervision

DOS currently is implementing examination guidance for safety and soundness examiners and developing training for technical specialists.

*Cynthia Bonnette, Examiner
Chairman, New Banking Technologies Task Force
(202) 898-6583*

*Stephen White, Information Systems Review Examiner
Chairman, Information Systems Subcommittee
Federal Financial Institutions Examination Council Task Force on Supervision
(202) 898-6923*

Division of Compliance and Consumer Affairs

DCA is reviewing new banking technologies from a consumer protection, fair lending and CRA perspective to provide guidance on compliance matters. DCA also is coordinating outreach efforts with consumer community groups.

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Office of Policy Development

OPD provides leadership in developing FDIC policies, including those addressing new banking technologies. The office coordinates several interdivisional electronic banking efforts and represents the FDIC on the interagency U. S. Treasury Consumer Electronic Payments Task Force.

*Sharon Powers Sivertsen, Director
(202) 898-8710*

Related Web Sites

FDIC	http://www.fdic.gov
FFIEC	http://www.ffiec.gov
NETBanker	http://www.netbanker.com
Bankweb	http://www.bankweb.com
National Computer Security Assoc.	http://www.ncsa.com
RSA Data Security Inc.	http://www.rsa.com
Smart Card Resource Center	http://www.smart-card.com
American Bankers Association	http://www.aba.com

Kansas City Region -- The Cattle Sector Remains a Concern

- The Kansas City Region's nonfarm job growth has kept pace with the national average since 1994. However, tight labor markets could lead to increasing wage costs and slower economic growth.
- The cattle sector shows some distress from continued low cattle prices.
- Strong demand for soybeans, both domestic and foreign, coupled with low stocks, have raised soybean prices to levels not seen since 1988.

Region's Nonfarm Job Growth Pacing U.S.

The Kansas City Region continues to keep pace with the broader national economy. Although the rest of the nation experienced a decline in nonfarm employment during the last recession, the Kansas City Region continued to add jobs at a very slow rate. As a result, nonfarm job gains between 1990 and 1996 totaled almost 13 percent in the Kansas City Region, while the nation grew by just under 9 percent. Since the end of 1994, the Region's pace of job growth has matched the nation's. Chart 1 highlights these trends.

The Region's manufacturing sector (about 16 percent of total jobs) also has outperformed the national trend during the last five years. The factory job count grew an average of 1.3 percent per year between 1991 and 1996 for the Region, while it was essentially unchanged for the nation.

Tight Labor Markets Have Not Yet Resulted in

Wage Inflation

Relatively modest population growth, together with steady employment gains, have resulted in a declining unemployment rate during the last several years (see Chart 2). Some of the Region's states saw annual average unemployment drop below 3 percent last year (Nebraska's average rate has been at or below 3 percent since 1990).

Concerns have been raised that tight labor markets, particularly in highly skilled manufacturing, will lead to increased wage inflation and a consequent slowing of growth in the Region. Rising manufacturing wage rates would affect Minnesota and Missouri more than other states given their higher concentrations of industrial employment.

Thus far, however, increases in the Region's manufacturing wages (average hourly earnings) remain subdued.

CHART 1

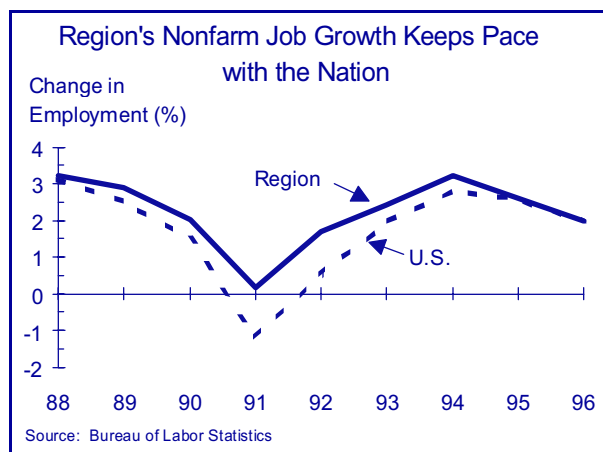
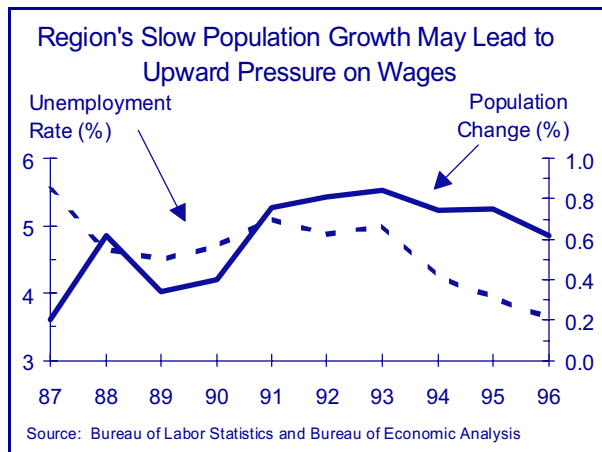


CHART 2



During this decade, average manufacturing earnings in the Kansas City Region have moved up at a slightly slower pace than that seen for the nation as a whole. For example, in 1996 the Region experienced an average increase in hourly earnings of 2.9 percent -- somewhat below the nation's average increase of 3.3 percent.

Kansas City Metropolitan Area Showing Signs of Strong Growth

During the last several quarters, Kansas City has witnessed a series of new hotel and motel additions aimed at increasing the city's appeal as a convention destination (the city doubled the size of its convention center three years ago).



Current plans call for a 22 percent increase in room inventory by the end of 1997 (an additional 4,000 rooms added to the existing stock of about 18,500). About 40 percent of the proposed room additions would arise from four casino projects and two downtown renovations. The boom in construction primarily has been funded by Real Estate Investment Trusts (REITs) and other investment sources (to a lesser extent banks). Lower-end properties, which can be readily built and start generating cash flow quickly, have been a favorite of investors. *However, there have been concerns over the potential for an overbuilt market -- particularly in the lower-end properties around the city's outskirts, the fastest growing segment of the market.*

Retail space also has been added at a steady pace, as national chains expand in the area. Construction activity has spread south of Kansas City; recently rezoned wheat fields in the southern suburbs have provided an excellent site on which to build "power centers" and other

large retail facilities. Most of the growth has been in the Overland Park, KS area. Retail vacancy rates in the greater Kansas City metro area are just under 8 percent, according to research by a local firm, **Cohen-Esrey Real Estate Services**.

The market for industrial space is extremely tight in Kansas City. **CB Commercial** reported an average industrial vacancy rate of only 1.7 percent during the fourth quarter of last year. In fact, industrial vacancy rates hit an all-time low for the Kansas City metro area last year, averaging 2.9 percent.

Outlook for Cattle Remains Uncertain

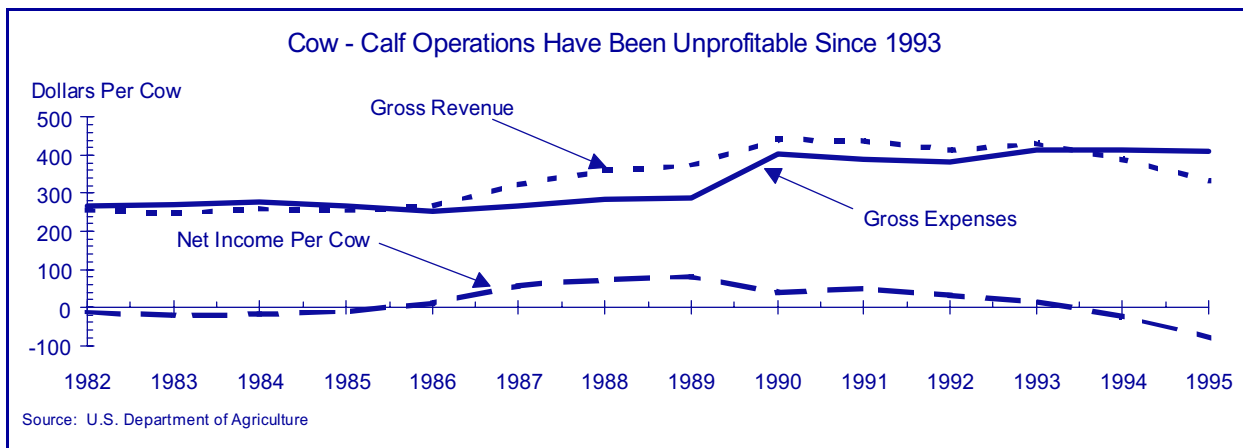
The cattle industry has long been important to the Kansas City Region. The large semi-arid open spaces in Kansas, Nebraska and South Dakota, coupled with close proximity to feed supplies, make it ideally suited for cow-calf operations and feedlots. Table 1 (next page) shows the cattle sector's importance in terms of cash receipts. In three of the seven states in the Region, cattle are the number one commodity.



Chart 3 shows the comparison of the gross value of production to total cash expenses (break-even costs) for U.S. cow-calf producers. The **U.S. Department of Agriculture** (USDA) data show that since 1993 cow-calf operations have been unprofitable. Moreover, the losses experienced during the latest downturn are more pronounced than during the early 1980s, the last episode of unprofitability.

Most industry sources believe that profitability will

CHART 3



begin to improve for cattle producers in 1997. Importantly, the big corn crop of 1996 has lowered corn prices by about 25 percent compared to March 1996 levels, drastically reducing cattle ranchers' feed costs. In addition, cattle numbers are expected to decline during the next several years, setting the stage for increases in average feeder cattle and calf prices.

However, the severe winter experienced in North Dakota and South Dakota has negative implications for cattlemen in those states. The numerous blizzards caused tens of thousands of cattle deaths in the northern half of South Dakota and in the south-central portion of North Dakota. Although cattlemen typically do not carry insurance to cover weather-related losses, federal disaster aid may mitigate damages.

Compounding cattle ranchers' problems, the persistent cold weather has caused increased consumption of feed by the surviving cattle, increasing costs for producers. In addition, complications with calving are expected due to the stress placed on cows and unborn calves by the cold temperatures and heavy snow accumulation.

Implications: Since most cattle operations in North Dakota and South Dakota are small (100 head or less), there are concerns that some cattlemen may not have the necessary resources to manage financially through this difficult time. In addition, these small operations may be affected further by saturated fields and flooding when record snow levels melt this spring. While increased field moisture should not affect larger cattle operations, many small cattle farmers may be affected because they

typically raise crops as well as cattle.

Grains: 1997 - The Year of the Soybean?

Strong demand for soybeans, both domestic and foreign, coupled with low stocks, have raised soybean prices to levels not seen since 1988. The USDA expects that the U.S. will see an all-time high soybean crush of 1,420 million bushels in the 1996-1997 crop year. Cash prices for soybeans, currently in excess of \$8.00 a bushel, are pushing the USDA average market-year price range to \$6.90 to \$7.30 per bushel.

The current high soybean price levels may be influencing farmers' planting decisions. The USDA projects that total U.S. soybean plantings will be 7 percent higher in 1997 than in 1996. In the Region, farmers are expected to plant 12 percent more soybeans than last year. Whether the current price levels are sustainable will depend in part on the volume of foreign supplies from sources such as Brazil, as well as the response in demand to the current high price level. For example, last year at this time, early supply concerns coupled with strong demand resulted in high wheat prices during the spring. However, these early high price levels had a dampening effect on demand for wheat later in 1996, resulting in a subsequent sharp decline in wheat prices to more normal levels. This year, watching for similar changes in supply and demand forces for soybeans also will be important.

Winter Wheat Update: The winter wheat crop in

TABLE 1

CATTLE ARE BIG BUSINESS IN THE KANSAS CITY REGION					
STATE	NATIONAL RANKING	CASH RECEIPTS (IN MILLIONS)	% OF TOTAL U.S. CATTLE RECEIPTS	% OF TOTAL STATE COMMODITY RECEIPTS	COMMODITY RANKING WITHIN THE STATE
KANSAS	2	\$4,235	12.5	56.3	1
NEBRASKA	3	4,158	12.2	47.8	1
IOWA	6	1,705	5.0	15.5	4
S. DAKOTA	8	1,046	3.1	30.9	1
MINNESOTA	9	835	2.5	11.9	5
MISSOURI	11	660	1.9	15.0	2
N. DAKOTA	20	366	1.1	11.6	2
REGION		\$13,005	38.3		
SOURCE: U.S. DEPARTMENT OF AGRICULTURE					

Kansas was rated 82 percent “good to excellent” in USDA’s March crop report. This rating is good news for wheat growers in Kansas, where last year at nearly the same time the crop was rated only 12 percent good to excellent. While yields are projected to improve, many analysts are less than bullish on wheat in the coming months. At the USDA’s annual Agricultural Outlook Forum in February, a senior USDA economist stated that prices for wheat could bottom out sometime between July and September in a range as low as \$3.25 to \$3.35 per bushel. Demand concerns are apparently the driving force. Not surprisingly, farmers who can rotate between wheat and other crops, such as corn and soybeans, are expected to do so this spring.

Implications: The planting flexibility granted in the 1996 Farm Bill perhaps makes planning a more challenging exercise. Farmers must now more carefully evaluate crop pricing dynamics to assess whether price levels early in the crop year can be sustained. Similarly, hedging techniques may take on a relatively greater role in the management of farm operations. The enhanced ability to respond to changes in the market, especially in areas where crop rotations are more feasible, provides positive opportunities for those farmers that make the right decisions but can be detrimental for those that do not. Lenders in areas where crop rotations have been less common must be cognizant of the level of experience farmers have with crops that they are not accustomed to growing.

Pork Producers Expected to Enjoy a Profitable Year

Lower feed costs and continued strong prices should

benefit the Region’s pork producers in 1997, according to industry experts. The most recent ***Hogs and Pigs Report*** from the USDA indicated that the breeding herd increased slightly from the last year’s level. Iowa, Minnesota and Nebraska registered increases on a year-over-year basis for the first time in two years. An industry analyst suggests that until the expansion progresses further, tight supply should allow for prices well above \$50 per cwt. into the autumn.

The recent suspension of exports of pork from Taiwan due to an outbreak of foot-and-mouth disease in their pig herd may have positive implications for U.S. pork producers. Taiwan is currently the largest provider of imported pork to Japan. According to current World Health Organization rules, all exports must be suspended for at least one year. *The suspension may be an opportunity for U.S. suppliers to gain additional market share in the large Japanese market.* The length of the suspension most likely will determine the amount of the improvement in market share.

*Craig A. Rice, Senior Regional Analyst
Norman Williams, Boston Regional Economist*

Financial Markets

- While demand for asset-backed securities continues to be strong, further deterioration in consumer credit quality could have adverse effects on both investors and issuers.
- Although there has been little net change in the Treasury yield curve between September 30, 1996, and early March 1997, rates in the 5-year to 30-year segment of the yield curve did fluctuate modestly during this time period.
- During the fourth quarter 1996, the S&P Composite Bank Index outperformed S&P 500, gaining 12 percent, compared to an almost 8 percent gain for the S&P 500. The Kansas City Region's Bank Index outperformed the S&P 500 also but by a slim margin of only 22 basis points.
- Banks' price/earnings ratios relative to the broader market have been trending upward since 1994, perhaps signaling an improved perception of the quality of bank earnings.

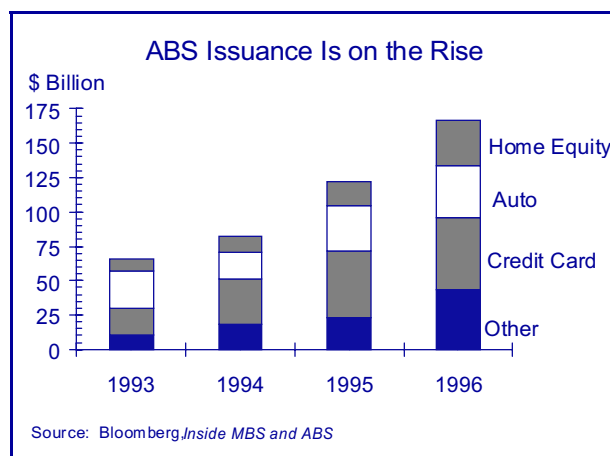
The Asset-Backed Securities Market: The Effects of Weakened Consumer Loan Quality

Asset-backed securities (ABS) are debt securities that are backed by loans such as credit cards, car loans, and home equity loans. Over the past ten years, the ABS market has grown dramatically. In 1996, the issuance of ABS was \$167 billion, up from \$65 billion issued in 1993 as illustrated in Chart 1. Commercial banks and credit card companies accounted for approximately 35 percent of total ABS issuance last year. Major buyers of ABS were mutual funds, insurance companies, corporations, and foreign and domestic banks. Although it is difficult to quantify the amount of bank investment in the ABS market, market participants have observed that small and mid-sized banks have recently increased their holdings of ABS.

Monoline credit card banks and large banks with significant credit card operations have been particularly active ABS issuers. Issuing banks generally structure ABS transactions as nonrecourse sales (loans that cannot be "put back" to issuers upon default), which results in the removal of the assets from the bank's balance sheet and lowers capital requirements. In order to receive investment grade ratings on their ABS, issuers must provide credit support either in the form of over-collateralization, reserve accounts, or third party credit enhancement from bond insurers.

Bank issuers benefit from the sales treatment of assets into the security without completely severing their economic interest in the income generated by the assets. The economic interest results when the revenue generated by the sold assets after charge-offs, servicing fees,

CHART 1



and interest coupon payment is recognized as income by the issuer. This surplus is referred to as excess spread. Banks that issue ABS usually continue to service the underlying assets, which not only generates servicing income but also permits customer relationships to continue.

Delinquency and charge-off rates rose in 1996 on consumer loans, particularly in credit cards and auto loans. Despite this rise, the difference between ABS and Treasury yields of similar maturity did not increase. As Chart 2 (next page) shows, the average spread to the two-year Treasury note on selected ABS products continued to tighten during 1996. The lack of widening spreads despite the overall weakening in consumer credit quality reflects strong demand from an expanding investor base, which increasingly includes overseas

buyers. Spreads on selected credit card and auto ABS products began to increase during the first quarter of 1997, however, as investors reacted to higher than expected charge-offs reported by some of the larger issuers.

The increasing frequency of rating agencies' reviews for possible downgrades of credit card transactions, as well as problems in the auto finance sector, have raised some concerns in the ABS market. How would a further deterioration in consumer credit affect the ABS market? For the issuer, higher charge-offs, absent a corresponding increase in fees or rates, reduces the excess spread from the ABS. If deterioration worsens, the ABS face potential rating downgrades. This situation may compel the issuer to improve the overall loan quality in the ABS or face what is termed an "early amortization" event. An early amortization event may result in the termination of the ABS issue prior to the maturity date. Once an early amortization occurs, new receivables associated with the accounts in the asset-backed security no longer move into the security but must be funded by the bank on their balance sheet and accounted for in determining capital requirements. In addition, an issuer's access to the ABS market may become more costly after an early amortization if investors demand higher yields on subsequent issues.

For the investor, the threat of a ratings downgrade usually impairs the market value of the security. Investors also may forfeit some interest income in an early amortization because principal may be paid prior to the scheduled maturity date. ABS investors would lose principal, however, only if the deterioration in the quality of the underlying loans is severe enough to deplete the entire credit support. The high level of credit support demanded by rating agencies on existing

ABS deals minimizes the risk of principal loss by investors.

During 1996, some bankcard issuers took steps to prevent a ratings downgrade or a possible early amortization. Methods used by bank issuers to support deteriorating ABS have included the sale of new receivables at a discount, the repurchase of low quality receivables from the issue, and the infusion of additional cash into a reserve account of the ABS. However these strategies were specifically cited by the Office of the Comptroller of the Currency (OCC) as actions that could be considered recourse and require full risk-based capital treatment for the assets in the particular ABS issue. The FDIC is working with other regulatory agencies through the Federal Financial Institutions Examination Council (FFIEC) on new Risk-Based Capital Guidelines that are expected to address limitations on post-sale actions and capital requirements for direct credit substitutes or credit enhancements for ABS.

Given the continuing trend of higher charge-offs and delinquencies for credit card loans, investors consider the ABS market less homogeneous in terms of issuer quality and therefore are scrutinizing the securitizations of issuers more closely. Although the risks vary by ABS issuer, banks that issue or invest in the ABS market should be cognizant of the changing market conditions and potential risks associated with ABS.

Changes in Interest Rates and Bond Values

Chart 3 (next page) shows little change in the Treasury yield curve between September 30, 1996, and early March 1997. What this chart does not show, however, is how rates in the 5-year to 30-year segment of the yield

CHART 2

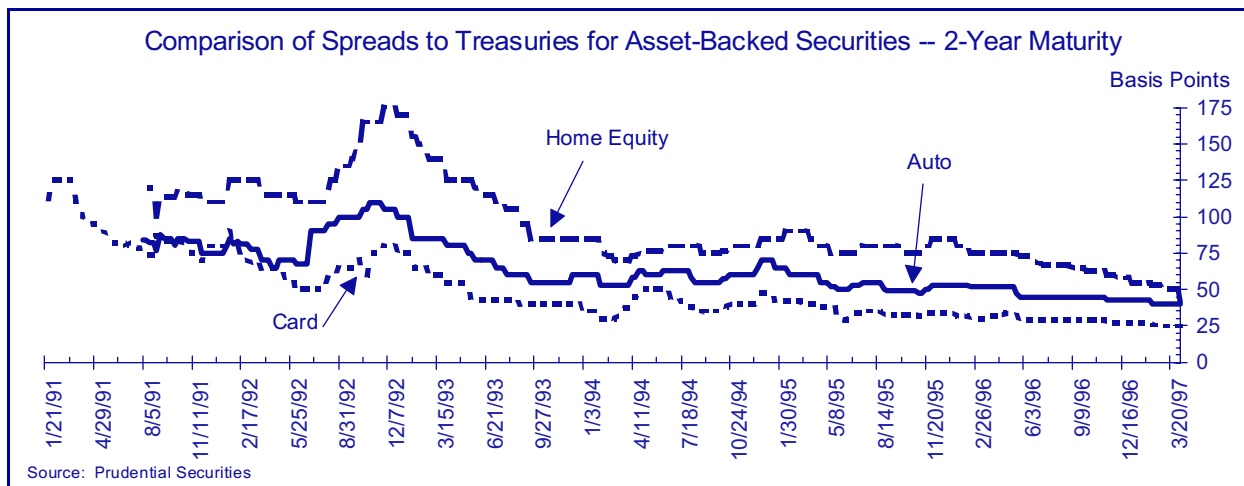
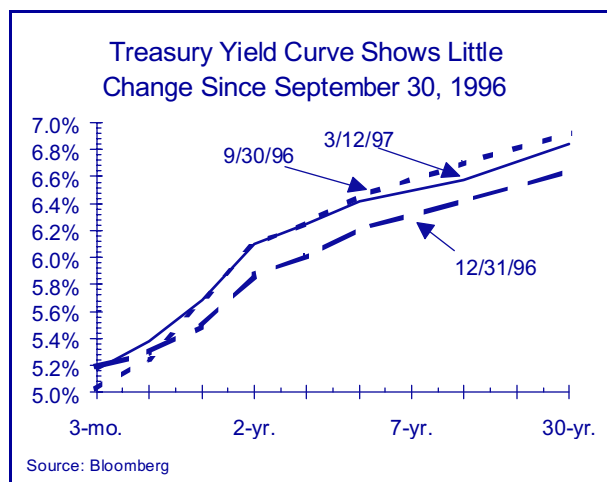


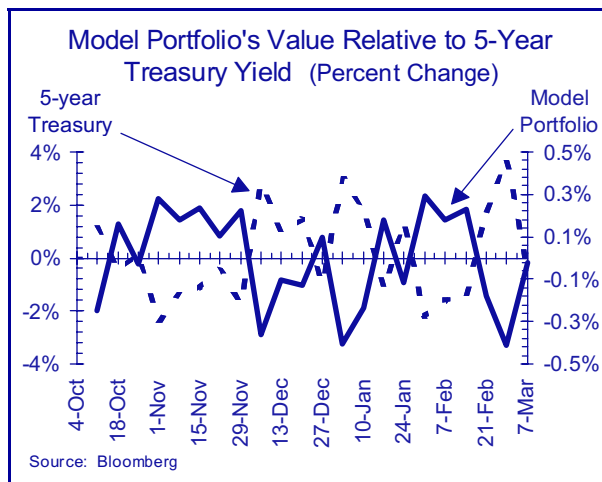
CHART 3



curve fluctuated during this time period. The path of yields on Treasury bonds with 5-year through 30-year maturities changed directions four times, rising or falling by more than 30 basis points. Movements in the shorter segment of the yield curve have been less pronounced.

In order to consider the effect that these rate swings may have had on banks' fixed income portfolios, Chart 4 shows the percent change in the yield on the 5-year Treasury and the percent change in the market value of a model bank portfolio created by the Division of Insurance. The presentation of this model portfolio extends an analysis that was introduced in the first quarter 1997 edition of the *Regional Outlook*, which looked at the market values of several common fixed income instruments relative to interest rate movements.

CHART 4



In order to enhance the model portfolio's applicability to bank portfolios, the type and amount of the securities chosen for the portfolio are based on an aggregation of securities-related Call Report data. The limitations of Call Report data concerning the maturity distribution of securities required that assumptions be made when choosing the maturity of the securities for the model portfolio. An effort was made, however, to construct a model portfolio that approximates, in the aggregate, the maturity distribution of the aggregate commercial bank portfolio. The model portfolio is shown in Table 1.

As shown in Table 1, the total market value of the portfolio changed less than one-half of 1 percent since September 30, 1996. The portfolio's period-high value, representing a 1.51 percent increase from September 30, 1996, occurred on November 29, 1996, when the 5-year

TABLE 1

TYPE OF SECURITY	PAR VALUE	PERCENT OF PORTFOLIO	MATURITY OR WAL	PERCENT CHANGE FROM 9/30/96 TO 12/31/96	PERCENT CHANGE FROM 12/31/96 TO 3/12/97	PERCENT CHANGE FROM 9/30/96 TO 3/12/97
U.S. TREASURY 5.6%	2,000	20%	1YR	0.35%	-0.05%	0.30%
FNMA AGENCY 5.8% CALLABLE	1,200	12%	2YR	0.59%	-0.25%	0.34%
STATE COUNTY MUNICIPAL GO 4.8%	800	8%	11YR	1.95%	-0.64%	1.95%
FNMA MORTGAGE PASSTHROUGH 7.5%	3,000	30%	8YR	1.08%	-0.30%	0.78%
FNMA (REMIC) 8.0% PAC	2,000	20%	2.5YR	0.58%	-0.68%	-0.10%
CREDIT CARD ASSET-BACKED SECURITY	1,000	10%	5YR	0.10%	0.00%	0.10%
TOTAL	10,000	100%	4.85YR	0.77%	-0.29%	0.48%

Treasury rate fell to its period-low of 5.83 percent. Observe that, while longer term rates fluctuated modestly over the reporting period, the reasonably short weighted average life (WAL) of the portfolio further moderated the value changes sustained by the portfolio.



Changes in the value of the model portfolio demonstrate a higher correlation to changes in the 5-year Treasury yield than to other maturities along the yield curve because the 5-year bond's maturity better matches the WAL of the model portfolio. Even though the 30-year Treasury rate is often cited as a benchmark for daily rate changes, it may not be the most significant rate in assessing exposures of bank securities portfolios to changes in interest rates.

On March 25, 1997, the Federal Reserve Open Market Committee met and raised the target federal funds rate 25 basis points to 5.50 percent. By the following day, the 5-year Treasury yield had risen to 6.66 percent, 23 basis points higher than the 5-year Treasury yield dated March 12, 1997, displayed in Chart 3 (previous page). The rise in rates from March 12 to March 26 caused the model portfolio's market value to fall 0.56 percent to \$9,965.

This model portfolio will be used regularly to show the effects on bond values of interest rates movements from quarter to quarter. It also will be used from time to time to illustrate how investment choices that portfolio managers make concerning duration, optionality, and other risk factors affect a portfolio's relative volatility.

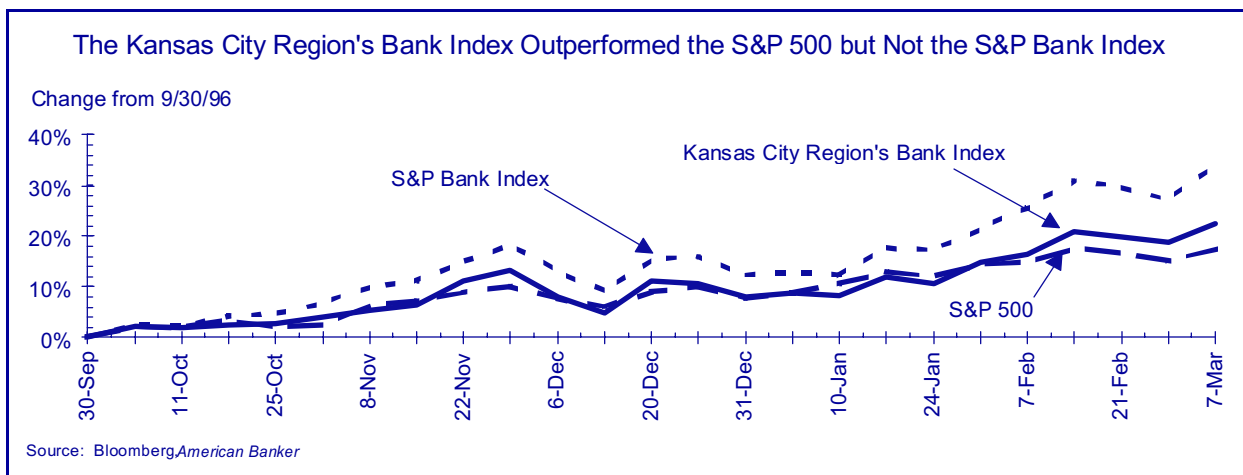
Banks' Stock Prices and Price/Earnings Ratios Continued to Rise in 1996. Is the Market Im-

proving its Perception of the Quality of Bank Earnings?

During the fourth quarter of 1996, the S&P Composite Bank Index outperformed the S&P 500, gaining 12.37 percent compared to a 7.77 percent gain for the S&P 500. The fourth quarter results topped off a year during which the S&P Composite Bank Index gained 37 percent compared to a 20 percent gain for the S&P 500. As shown in Chart 5, the Kansas City Region's Bank Index (KCRBI) gained 7.99 percent in the fourth quarter 1996. This performance, which significantly lagged the S&P Composite Bank Index, was due primarily to First Bank System, Inc., the second largest bank holding company in the index, which gained only 2 percent during the quarter. The KCRBI gained almost 36 percent for the full year 1996: enough to outperform the S&P 500, but not the S&P Composite Bank Index. The year's moderate economic growth, contained inflation, and favorable interest rates are credited for providing a friendly environment for bank stocks. As 1997 began with much the same economic conditions, bank equities have continued to do well. The KCRBI is up a more than 13 percent compared to an almost 20 percent gain for the S&P Composite Bank Index and a 9 percent gain for the S&P 500, through March 7, 1997.

While appreciating stock prices provide an obvious positive signal about the health of the industry, the market provides other information about the prospects for the industry through the price/earnings (P/E) ratio. The P/E ratio presents the price of a company's stock as a multiple of its earnings per share and is derived by dividing the stock's market value by the company's earnings per share. Typically investors are willing to pay a higher price for a company with earnings that are expected to be consistent and growing. However, firms

CHART 5

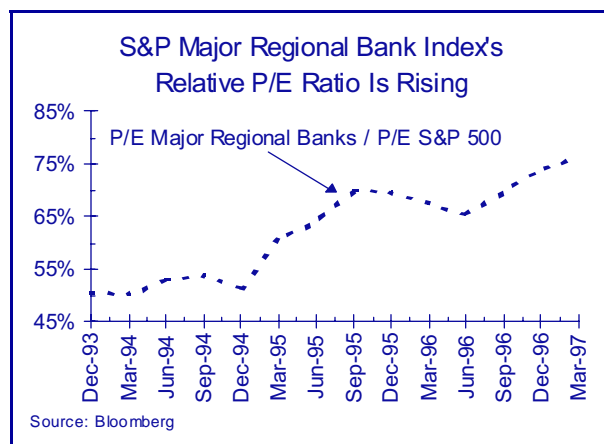


with more volatile earnings are generally penalized by investors in terms of stock price and lower P/E ratios. Generally, a higher P/E ratio can be interpreted to mean that investors have more confidence in the outlook for future earnings performance.

The relationship between bank P/E ratios and the P/E ratios for the broader market provides further insight into the market's perception of the quality of bank earnings compared to other firms. Historically, bank P/E ratios have been lower in the aggregate as compared to the rest of the market. The rationale posed for this discounted bank P/E ratio relative to the broader market has been that the primary sources of bank revenue, deposit taking and lending activities, traditionally have been viewed as being more volatile because they are prone to rising and falling with changes in the business cycle. For example, despite recording some of the highest quarterly return on equity averages ever at the end of 1993, the P/E ratio of the major regional bank index was at a level that was still only about 50 percent of the broader market P/E.

Over the past two years the magnitude of the banking sector's P/E discount has declined. As seen in Chart 6, the P/E discount has gone from 50 percent to only 24 percent (a relative P/E ratio of 76 percent). The higher P/E ratio may represent a view by market participants that bank earnings are becoming less sensitive to the business cycle, perhaps as a result of geographic or product-related diversification and more efficient man-

CHART 6



agement of overhead expenses. Another factor contributing to higher bank P/E ratios could include speculation on bank stocks as investors anticipate potential acquisitions.

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Regional Banking Conditions

- Profitability in 1996 was down slightly from 1995, but overall earnings performance for banks in the Kansas City Region remains favorable.
- Credit card loans continue to show elevated levels of charge-offs.
- Weaknesses in the cattle sector are affecting a number of small farm banks in the Region.
- Farm banks are facing increased competition for borrowers.

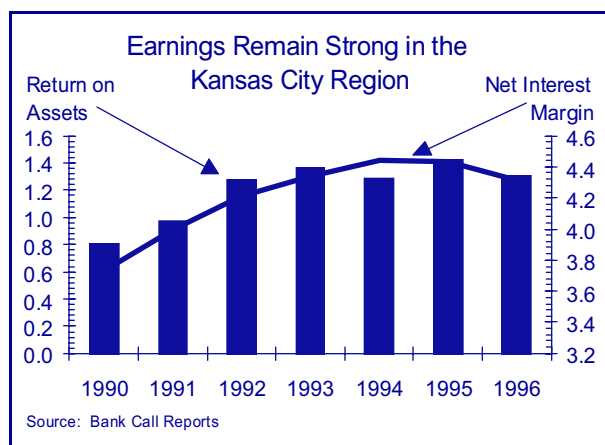
Profitability and Asset Quality Measures Are Mostly Stable

Insured institutions in the Kansas City Region reported an average net interest margin and return on assets of 4.3 percent and 1.3 percent, respectively, in 1996, a moderate decline from 4.4 percent and 1.4 percent, respectively, reported in 1995 (see Chart 1). Both indicators exceed the national averages for 1996 of 4.1 percent and 1.1 percent, respectively.



Reported asset quality remains good. Nonperforming asset levels have been stable for the past three years at 0.65 percent of total assets. Net charge-offs increased from a year-end 1995 rate of 0.48 percent of loans to 0.65 percent in 1996. The increase is largely a result of continued weaknesses in credit card loans.

CHART 1



Credit Card Charge-Offs Remain High

Banks in the Region charged-off 5.30 percent (annualized) of their credit card loans during the fourth quarter of 1996. This level represents a slight increase from the third quarter figure of 5.24 percent. Institutions with assets of \$500 million to \$1 billion were affected the most; they saw a 10 percent increase in their charge-off ratio for the quarter, bringing their annualized rate to 5.65 percent.

Cattle Ranchers' Difficulties Are Affecting Banks in Nebraska and South Dakota

Because of the heavy dependence on the cattle sector in Nebraska and South Dakota, cattle ranchers' problems have a pronounced effect on farm banks in those states. Over the past several years, the Region's cattle sector has come under a great deal of stress (see *Kansas City Region -- The Cattle Sector Remains a Concern*), as a result of persistently depressed prices and severe winter storms. Recent surveys by the *Federal Reserve Banks of Minneapolis and Kansas City* reported an increase in forced liquidations of cattle operations. In addition, the *FDIC's fourth quarter 1996 Underwriting Survey* of its examiners provided further evidence of weakness in the cattle sector. In that survey, 60 percent of examiners in Nebraska and 50 percent in South Dakota reported moderate increases in carryover debt, compared to 19 percent for the U.S. as a whole.



A potential concern for bankers is that debt-to-equity ratios for farmers in these states are among the highest in the nation. Nebraska and South Dakota farmers have average debt-to-equity ratios of 26 percent and 25 percent, respectively, compared to the U.S. average of

18 percent. Moreover, in contrast to the U.S. average, debt-to-equity ratios of farmers in Nebraska and South Dakota have increased since 1991. Because of their higher leverage, farmers in these states may be more vulnerable to prolonged periods of operating losses.

South Dakota's small farm banks have elevated levels of nonperforming loans, due in part to the problems facing cattle ranchers. As illustrated in Chart 2, South Dakota's 79 small farm banks (defined in this article as banks with less than \$100 million in total assets and more than 25 percent of their loan portfolio invested in agriculture production and real estate) have reported higher levels of nonperforming assets than the rest of the Region's banks over the past several years. Year-end 1996 results show that small farm banks in South Dakota had nonperforming assets equal to 1.2 percent of total assets, up 24 percent from year-end 1995. By comparison, nonfarm banks of similar size in South Dakota reported a nonperforming loan ratio of about 0.75 percent.



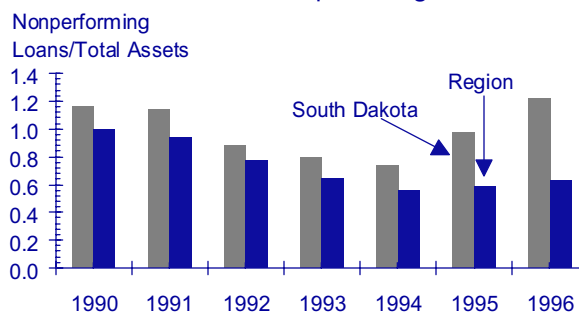
Concerns over rising nonperforming loans in small South Dakota farm banks are mitigated to some extent by their strong capital and earnings. Capital levels for these banks compare favorably to their peers in the Region with Tier 1 capital of 11.6 percent (see Chart 3). Profitability also is good, with return on assets of 1.16 percent, down slightly from 1.22 percent at year-end 1995 (see Chart 4). Of course, any detrimental effects on cattle operations resulting from the severe winter weather would not yet be reflected in these numbers.

Farm Banks Face Increased Competition for Borrowers

During the first half of the 1990s, banks in the Region

CHART 2

South Dakota's Small Farm Banks Show Elevated Levels of Nonperforming Assets



Source: Bank Call Reports

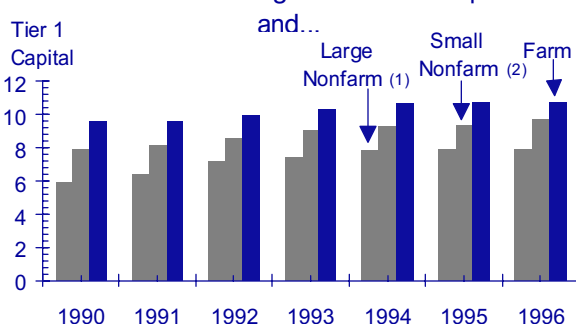
gradually increased their share of total farm debt. Chart 5 (next page) illustrates this trend. Recent information, however, suggests that increased competition may challenge banks' market share.

Farm Credit banks, having finally put the farm crisis of the mid-1980s behind them, are aggressively seeking to recapture market share. Their size facilitates aggressive marketing efforts, and they have instituted expedited underwriting processes that enable them to compete effectively with small local institutions. *In addition, Farm Credit banks reportedly have been aggressively pricing farm loans, making it more difficult and potentially costly for bankers to compete for borrowers who make decisions based strictly on interest rates.*

The market for farm operating loans, a niche traditionally served by small farm banks, is under pressure from other nonbank competitors in addition to Farm Credit banks. Large seed companies, equipment manufacturers

CHART 3

Farm Banks Have Higher Levels of Capital and...

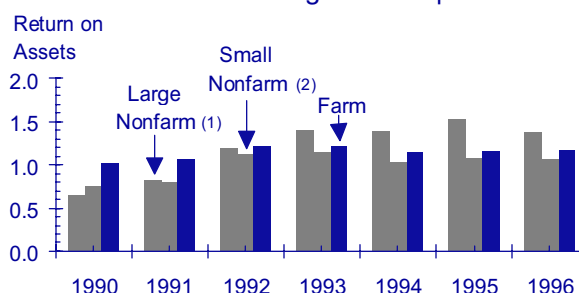


Source: Bank Call Reports

(1) Total Assets Greater than \$100 Million
(2) Total Assets Less than \$100 Million

CHART 4

...Their Earnings Recently Have Been Less Volatile than their Larger Counterparts.



Source: Bank Call Reports

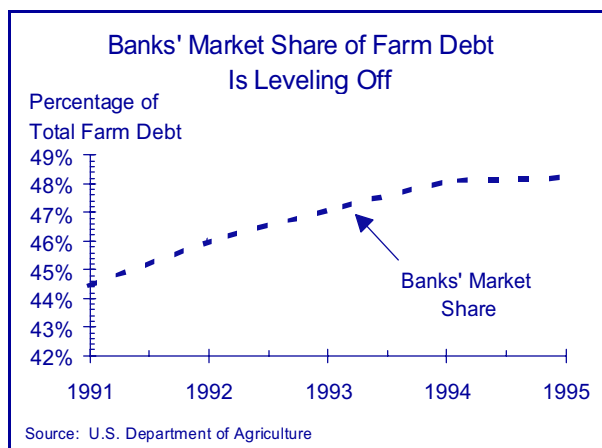
(1) Total Assets Greater than \$100 Million
(2) Total Assets Less than \$100 Million

and farm supply companies are actively seeking new lending relationships.

These competitive pressures on banks are intensifying during a period when the 1996 Farm Bill may create additional risks for their borrowers in terms of increased price and income volatility. Interest rates on farm operating loans may adjust to account for this additional risk. *Alternatively, the increased competition for borrowers may put pressure on banks to lower interest rates on loans or relax underwriting standards to maintain loan portfolio volume.* Under such a scenario, farm banks' net interest margins could be affected by the lower rates, or asset quality problems could increase if banks compromise underwriting standards to maintain current loan yields.

On the positive side, small farm banks appear well positioned to take on additional competition. They are better capitalized and their earnings recently have been less volatile than similar-sized nonfarm banks (see Charts 3 and 4 previous page). They also have long-standing relationships with their customers. However, the ability to retain these customers on both sides of the balance sheet, without sacrificing credit quality or profitability, may be the farm banks' biggest challenge in the coming years.

CHART 5



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John M. Anderlik, Financial Analyst*

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